Although the 2002 Filing Season Was Completed Timely, Customer Service Can Be Improved During Error Processing

September 2002

Reference Number: 2002-40-200

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 26, 2002

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Michael R. Phillips

FROM: Michael R. Phillips
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Although the 2002 Filing Season Was Completed Timely, Customer Service Can Be Improved During Error Processing (Audit # 200240022)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) timely and accurately processed individual tax returns in 2002. The audit focused on the implementation of the new tax legislation[1] and the identification of any delays in the processing of individual tax returns.

Overall, the IRS had a successful 2002 Filing Season. Despite an unusually large number of errors on returns, the IRS timely completed processing for all refund returns with only 5 percent of non-refund returns remaining. The large increase in errors was primarily caused by taxpayer confusion in correctly reporting any additional Rate Reduction Credit (RRC) due after receiving the advanced RRC credit refund in the summer of 2001 (for additional information, please see a prior Treasury Inspector General for Tax Administration (TIGTA) report[2]). These RRC errors represented approximately 57 percent of returns with errors[3] and contributed to a 308 percent increase in the volume of math error notices sent to taxpayers compared to last year.[4] Although, the RRC errors significantly increased inventory workloads at all 10 IRS processing centers, IRS employees did very well in meeting processing demands by working extra hours whenever necessary. Such efforts helped prevent any material slowdowns in processing and also ensured that taxpayer refunds were timely issued.

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[1] See Appendix V, Overview of Tax Law Changes That Affect Individual Income Tax Returns for the 2002 Filing Season.
[2] *Despite Some Problems, the Internal Revenue Service Properly Identified Returns With Rate Reduction Credit Errors During the 2002 Filing Season* (Reference Number 2002-40-142, dated August 2002).
[3] This is based on the assumption that a return has one RRC error.
[4] Math error notices in this report are defined as Computer Paragraph 12 Math Error notices. Such notices are issued to taxpayers when the IRS finds a math error on an individual income tax return with a refund of $1 or more.

However, in addition to timely processing taxpayer returns, the IRS could provide better customer service in the Error Resolution System (ERS).[5] For example, we identified 132,672 taxpayers that did not receive $25.7 million in Additional Child Tax Credit (ACTC)[6] after becoming eligible when the IRS corrected the return because of an RRC error.

Although management acknowledged the eligibility of these taxpayers and stated that applying the credit during error processing was possible, the IRS chose not to apply the credit. This decision was made because management believed these taxpayers would later be contacted in a planned outreach initiative intended to identify all eligible taxpayers that may not have claimed both the Child Tax Credit (CTC) and the ACTC and provide them a notice that could be used as a claim form to request the credit. However, the IRS has since concluded that, due to a limited budget and competing programming priorities, the outreach initiative cannot be implemented.

The IRS has no alternative plan that would ensure the ACTC is applied to the returns of the taxpayers affected by the original decision not to apply the credit during error processing. For additional information on the total number of affected taxpayers involved, including the 132,672 identified during the 2002 Filing Season, please see the proposed recommendation for contacting these taxpayers that was issued in a memorandum to the Director, Submission Processing, and was declined by the IRS in the TIGTA report titled, *Outreach Initiatives Need to Ensure Taxpayers Receive the Benefit of the Child Tax and Additional Child Tax Credits.*[7]

This report provides measurable benefits to tax administration by identifying taxpayer entitlements for 132,672 eligible taxpayers that did not receive $25.7 million in ACTC.[8] Our recommendation will help ensure the proper application of future tax benefits to eligible individuals during the filing season and reduce taxpayer burden by eliminating the need for submitting amended returns and other correspondence, while also improving processing by allowing the IRS to process tax return information only once. These benefits were previously discussed with the Director, Submission Processing.

<u>Management's Response</u>: The IRS management stated that they had not anticipated the error condition and acknowledged that their ability to react with proper programming and procedures to this one-time occurrence during the height of the filing season was limited. As a result, they believe they reflected proper customer focus by focusing on properly processing the millions of returns received.

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[5] An automated system to control tax returns with identified errors.

[6] All taxpayers can now receive a refund of their Child Tax Credit (CTC) when they have no tax liability; however, the refund is limited to 10 percent of a taxpayer's earned income over $10,000. The refundable CTC is commonly known as the ACTC.

[7] Reference Number 2002-40-203, dated September 2002.

[8] These 132,672 taxpayers represent part of a total population of 611,560 taxpayers that the TIGTA identified as potentially eligible to receive unclaimed ACTC totaling $238 million for Tax Year 2001. The measurable benefit for 132,672 of these taxpayers has been allocated to this report. Please see Appendix IV for more information.

While management agreed with our intent in making our recommendation, they disagree with implementing it because the ERS is not proactive, has limited capability and capacity, and would require complicated computer coding routines to use it as a proactive tool. Additionally, the high priority demands associated with implementing new tax law, maintaining existing systems, and supporting Modernization efforts prevent the IRS from implementing this recommendation. However, the IRS does intend to notify all taxpayers identified as affected by the condition we reported.

Lastly, management disagreed with our outcome measures. While they agreed with the computations, they believe it should have been shown as potential rather than actual since we do not positively know the eligibility of the taxpayers concerned.

Management's complete response to the draft report is included as Appendix VI.

Office of Audit Comment: Although this report does assume credit eligibility for the taxpayers identified during the review, we do acknowledge that there could be instances in which certain taxpayers may not be eligible for the credit. However, we are pleased that the IRS plans to notify all the taxpayers identified as to their potential eligibility for claiming the credit if appropriate. As such, we have revised our measurable benefit to reflect potential taxpayer entitlement of $25.7 million in unclaimed ACTC rather than actual entitlement.

While we believe our recommendation is worthy of further consideration, we recognize the limitations expressed by the IRS. We do not intend to elevate our disagreement concerning this matter to the Department of the Treasury for resolution and believe the IRS will continue working to overcome such limitations in the future.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

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Background

The filing season is an important time for the Internal Revenue Service (IRS) each year. It is during this time, from January 1 to April 15, that most individuals file their income tax returns and call the IRS if they have questions about specific tax laws or filing procedures. During the 2001 Filing Season, taxpayers filed returns totaling $690.6 billion in tax revenue.

The 2002 Filing Season included several significant challenges for the IRS, with the biggest being the implementation of the Economic Growth and Tax Relief Reconciliation Act of 2001[1] (EGTRRA). This legislation contained the largest tax cut ($1.35 trillion) in 20 years and included 85 major provisions requiring 441 tax law changes to be implemented by the IRS over the next 10 years. See Appendix V for an overview of the tax law changes that affected individual taxpayers for the 2002 Filing Season.

In 2002, the IRS planned to process individual income tax returns at 10 centers located on IRS Submission Processing Campuses (SPC) throughout the country. Of these 10 centers, 8 are Wage and Investment (W&I) SPCs and 2 are Small Business/Self-Employed (SB/SE) SPCs that also processed individual income tax returns during the 2002 Filing Season. At these centers, taxpayer returns and the related schedules are processed through the IRS' computer system and recorded on each individual's tax account. This computer system is made up of a complex series of processing sub-systems that are nationally linked and programmed to check the validity and math accuracy of the data provided. If an error is found, taxpayers are sent a notice that asks for additional information or explains any change that is made to the amount of tax due or refund shown.

The Treasury Inspector General for Tax Administration (TIGTA) coordinated this review from January 2002 through April 2002 with IRS executives and personnel in the IRS' W&I Operating Division in Atlanta, Georgia; the IRS' Submission Processing Headquarters offices in Cincinnati, Ohio; and New Carrollton, Maryland. Audit

[1] Public Law No. 107-16, 115 Stat. 38 (2001).

fieldwork was performed at three IRS processing centers located in Atlanta, Georgia; Austin, Texas; and Fresno, California.

This audit was conducted in accordance with *Government Auditing Standards.* Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The 2002 Filing Season Was Completed Timely Despite a Large Number of Unexpected Errors at Processing Centers

Overall, the IRS had a successful 2002 Filing Season. As of May 31, 2002, the IRS had received a total of 123.2 million individual tax returns (including 46.3 million received electronically, an increase of 16 percent over 2001). Despite an unusually large number of errors on the returns, the IRS timely completed processing for all refund returns with approximately 5 percent of non-refund returns remaining. The large increase in errors was primarily caused by taxpayer confusion in correctly reporting any additional Rate Reduction Credit (RRC) due after receiving the advanced RRC credit refund in the summer of 2001.

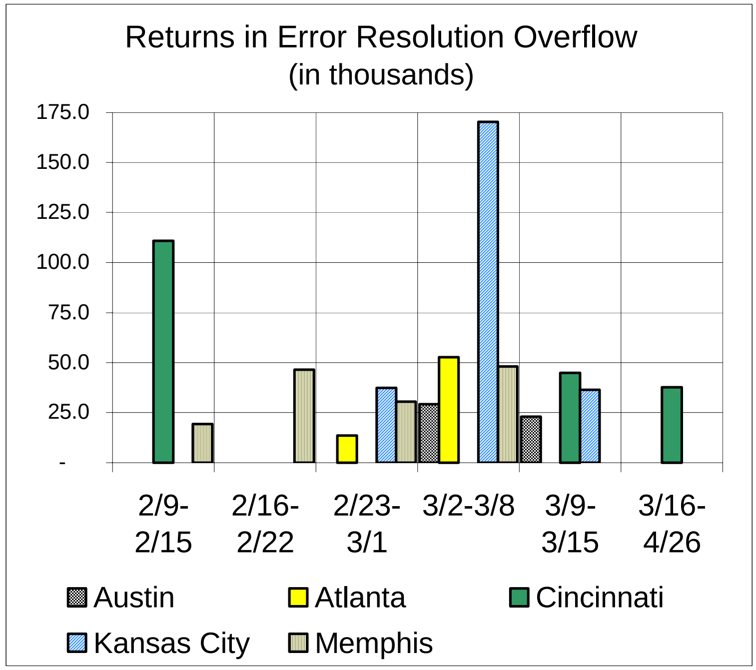
Over 7 million individual returns had been identified with RRC errors as of May 31, 2002, based on IRS data. This represents a total of 57 percent of all returns that had error conditions.[2] The volume of RRC errors is believed to have resulted from taxpayer confusion and tax law complexity. For additional RRC information, please see the prior TIGTA report titled, *Despite Some Problems, the Internal Revenue Service Properly Identified Returns with Rate Reduction Credit Errors During the 2002 Filing Season.*[3]

Errors strain the IRS' Error Resolution System (ERS)

The large volume of errors received caused the ERS' processing capacity at 9 of the centers to reach maximum or overflow status several times. The largest overflow conditions occurred during the 3-week period from February 23 to March 15, 2002, when 7 SPCs were unable to process a total of 523,665 returns. However, most overcame the overflow condition within 1 or 2 days with

[2] This is based on the assumption that a return has one RRC error.
[3] Reference Number 2002-40-142, dated August 2002.

none exceeding 4 days. The following chart shows the overflow volumes of the centers most affected from February 9 through April 26, 2002.



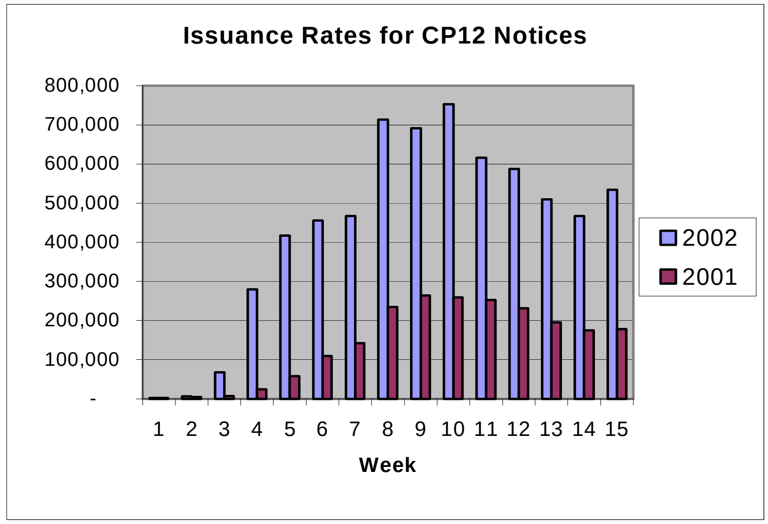
Source: The IRS report, ERS0340 – Error Resolution Unselected Records Inventory.

<u>Errors increase the volume of notices sent to taxpayers</u>

Any large increase in the volume of processing errors in turn causes a large increase in the number of taxpayer notices that must be issued to explain why changes were made to the tax returns.

During the 2002 Filing Season, the IRS issued over 6.5 million math error notices[4] between January 25 and April 26, 2002, with 6 million resulting from RRC errors. This total represents a 308 percent increase over the same type of math error notice issued during 2001, as shown in the following graph.

[4] Math error notices in this report are defined as Computer Paragraph 12 Math Error notices. Such notices are issued to taxpayers when the IRS finds a math error on an individual income tax return with a refund of $1 or more.



Source: IRS data from the Office of the Notice Gatekeeper.

The IRS did very well to timely meet its processing goals for 2002 despite the significant increase in the workloads of ERS and Notice employees at the 10 processing centers. These employees worked extra hours when necessary; however, the overtime paid to employees in the 8 W&I SPCs[5] in 2002 did not increase compared to the amount paid in 2001. Such efforts helped prevent any material slowdowns in processing and also ensured that taxpayer refunds were timely issued.

Thousands of Taxpayers Were Prevented From Receiving Additional Child Tax Credits Totaling $25.7 Million

Tax relief for low-income families was included in the EGTRRA tax law provisions for TY 2001 through modifications to the existing Child Tax Credit (CTC). These changes increased the credit amount to $600 for each qualifying child and expanded refundable CTC benefits to taxpayers with less than 3 qualifying children.

The refundable CTC benefit is referred to as the Additional Child Tax Credit (ACTC) and is payable up to 10 percent of a taxpayer's earned income in excess of $10,000. The Congress strongly conveyed in the EGTRRA legislation that the refundable child credit provisions should be fully effective in 2001 and that eligible taxpayers entitled to claim the credit be given the maximum benefit available.

[5] Overtime data for the two SB/SE SPCs, Ogden and Cincinnati, were not available.

Thousands of taxpayers were prevented from receiving ACTC because employees were not instructed to make a subsequent adjustment to give the taxpayer the benefit of the refundable ACTC after correcting the RRC error. This situation was identified early in the filing season by ERS management with the following possible actions forwarded to the IRS National Headquarters for consideration:
(1) compute the correct ACTC amount while still in the ERS and eliminate the need for an amended return;
(2) contact and have the taxpayer request the ACTC, or
(3) advise the taxpayer that he or she may be eligible for the ACTC.

We identified a total of 132,672 taxpayers that did not receive $25.7 million in ACTC after becoming eligible during the IRS' error correction process from January 1 through May 31, 2002. Although the IRS National Headquarters did acknowledge the eligibility of these taxpayers and stated that applying the credit during error processing was possible, it decided not to apply the credit because an initiative was planned to perform an automated outreach program at the end of the filing season.

This initiative would have identified all eligible taxpayers that may have not claimed both the CTC and the ACTC, including those whose returns had been processed through the ERS and provide them a notice that could be used as a claim form to request the credit. However, the IRS has since concluded that this initiative cannot be implemented because of limited resources and competing programming priorities. The IRS has no alternative approach to identify and refund the credit due the 132,672 taxpayers affected by the original decision not to apply the ACTC during the error resolution process.

For additional information on the total number of taxpayers affected, please see the TIGTA report titled, *Outreach Initiatives Need to Ensure Taxpayers Receive the Benefit of the Child Tax and Additional Child Tax Credits*.[6] A memorandum is included in that report that was issued to the Director, Submission Processing, with a proposed

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[6] Reference Number 2002-40-203, dated September 2002.

recommendation that the IRS consider using our return listings to contact the 132,672 taxpayers processed through the ERS and 478,888 other identified taxpayers that appeared eligible for the ACTC; however, the recommendation was declined.

The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98)[7] made widespread changes relating to the operations of the IRS. Goals of the Act included increasing public confidence in the IRS and making it a more efficient, responsive, and respected agency. The Congress mandated the IRS to review and restate its mission to increase its emphasis on serving the public and meeting taxpayer needs. The new mission statement stresses the importance of providing taxpayers with top quality service, and the IRS' Annual Performance Plan for Fiscal Year 2003 emphasizes improving the quality of service provided to taxpayers in filing their tax returns.

We believe this situation clearly shows that opportunities remain to help the IRS comply with its mission and improve the quality of service being offered to taxpayers. Recognizing these opportunities would allow the IRS to ensure the proper application of tax benefits to eligible individuals during the filing season and reduce taxpayer burden by eliminating the need for submitting amended returns and other correspondence, while also improving processing by allowing the IRS to only process tax return information once.

Recommendation

1. The Commissioner, W&I, should consider developing a proactive approach in the ERS to apply appropriate credits affected by the corrections made during error processing.

Management's Response: The IRS stated, "The ERS systems and supporting processes are not proactive. The system has limited capability and capacity and would require complicated computer coding routines for us to use

[7] Public Law No. 105-206, 112 Stat 703.

it as a proactive tool. The high priority demands associated with implementing new tax law, maintaining existing systems, and supporting our Modernization efforts prevent us from implementing this recommendation."

Office of Audit Comment: While we believe our recommendation is worthy of further consideration, we recognize the limitations expressed by the IRS. We do not intend to elevate our disagreement concerning this matter to the Department of the Treasury for resolution and believe the IRS will continue working to overcome such limitations in the future.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the review was to determine whether the Internal Revenue Service (IRS) timely and accurately processed individual income tax returns in 2002. The audit focused on the implementation of the new tax legislation and the identification of any delays in the processing of individual tax returns. The processing of immediate tax relief checks authorized by the Economic Growth and Tax Relief Reconciliation Act of 2001[1] (EGTRRA) was reviewed in a prior TIGTA report[2] and was not included in this review. To accomplish our objective, we:

I. Determined if the IRS correctly implemented new tax legislation during the 2002 Filing Season.

   A. Used automated procedures to extract data for returns meeting specific criteria from IRS records and selected samples from these populations. All statistical samples were selected with a 95 percent confidence level. Since actual error rates were unknown, initial samples were generally based upon expected error rates of 5 percent with a ± 3 percent precision rate. A judgmental sample was used if the total population could not be determined. The results of the samples were not used for any projections. We selected statistically valid samples of returns with Alternative Minimum Tax (AMT), Child Tax Credit (CTC), and Capital Gains and Losses.

      1. Reviewed 70 returns from the 1,914 returns processed with AMT through January 25, 2002, to determine if the correct AMT exemption amount was applied and the CTC was allowed to offset the AMT tax liability. We also reviewed a judgmental sample of 22 AMT notices for accuracy.

      2. Reviewed 75 returns from 96,325 returns filed the week of February 1, 2002, claiming CTC to determine if the CTC was accurately computed. Based upon the results of this review, we electronically identified for further analysis 611,560 returns filed through May 31, 2002, where the taxpayer is potentially eligible for the Additional Child Tax Credit (ACTC). This is discussed in more detail in the TIGTA report titled, *Outreach Initiatives Need to Ensure Taxpayers Receive the Benefit of the Child Tax and Additional Child Tax Credits*.[3] We also reviewed all 15 CTC notices issued with wrong taxpayer notice codes through February 8, 2002.

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[1] Public Law No. 107-16, 115 Stat. 38 (2001).
[2] *Despite Some Problems, the Internal Revenue Service Properly Identified Returns With Rate Reduction Credit Errors During the 2002 Filing Season* (Reference Number 2002-40-142, dated August 2002).
[3] Reference Number 2002-40-203, dated September 2002.

3. Reviewed 150 returns from 153,055 returns filed through March 8, 2002, reporting Capital Gains and Losses (Schedule D) to determine if the new reduced tax and capital gains rates were used. We also reviewed all 31 Schedule D notices processed through March 1, 2002, at the Fresno processing center for accuracy.

4. Electronically analyzed the tax rates for all 6,352 returns filed with a Parents' Election To Report Child's Interest and Dividends (Form 8814*)* through February 8, 2002, on which parents reported investment income belonging to children. We also electronically analyzed tax rates for all 106 returns filed with a Tax for Children Under Age 14 With Investment Income of More Than $1,500 (Form 8615) through February 8, 2002, to determine whether the new tax rates are being used for children's income that can be claimed on the parents' returns.

B. Manually screened incoming returns on January 30 and 31, 2002, and selected a judgmental sample of 30 individual returns. These returns were reviewed to determine whether the lower income tax rates had been correctly programmed. We also determined if procedures had been established to control special cases by monitoring 31 returns filed between January 29 and February 20, 2002, with the words "September 11, 2001, Terrorist Attack" at the Austin processing center.

C. Determined if changes in the tax law caused additional adjustments during the IRS' processing of returns by comparing weekly volumes of taxpayer notices to volumes from the prior year. We also identified 212 notices that were sent to taxpayers through March 1, 2002, to explain changes made to their returns that were related to new tax law changes or had Self-Employment tax or education credit issues. We reviewed a judgmental sample of 90 of these notices to determine if the notices were accurate.

II. Determined if the IRS properly planned for the Submission Processing Centers transition that resulted in changes to the filing locations for a significant number of taxpayers.

A. Determined if return volumes differed significantly from projected volumes by monitoring IRS pipeline status and service center production and inventory reports.

B. Evaluated whether taxpayers filed in the appropriate tax filing locations by matching ZIP code data from the IRS Returns Transaction File (RTF)[4] for 62,714,894 returns processed through March 28,2002, to a list of the intended service centers where each ZIP code should file.

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[4] The RTF contains tax return information transcribed during processing and includes other information such as math calculations.

III. Determined if the IRS has an accurate monitoring system to ensure that issues affecting the filing season are promptly identified.

A. Monitored the national IRS Submission Processing (SP) weekly calls and contacted local and national analysts to identify the tools used to monitor processing and to identify the emerging issues.

B. Monitored the Error Resolution System (ERS) inventories from various ERS reports produced between February 8 and April 26, 2002, to determine whether capacity issues for the ERS caused any processing delays in the resolution of errors on returns.

C. Contacted the Computer Assisted Review of Error Resolution System analysts in the Atlanta, Austin, and Fresno processing centers and monitored the IRS SP website, the IRS public website, and other applicable websites to determine what types of errors were being identified and how they were being resolved.

IV. Determined if the IRS had corrected problems previously identified by the TIGTA.

A. Evaluated whether procedures were revised for the validation of the secondary Social Security Number (SSN) to prevent erroneous denial of personal exemptions and the Earned Income Tax Credit. We reviewed a judgmental sample of 30 current tax year notices from 56 notices being sent to taxpayers informing them of an invalid SSN condition for the week ending March 8, 2002. We also reviewed the processing of 50 accounts judgmentally selected from the 10,981 accounts identified during the 2001 review.

B. Reviewed a capital gains notice for the current year to determine if incorrect notices sent to taxpayers in the previous year had been properly revised. These notices are computer generated eliminating the need to review additional notices.

C. Manually screened 1,005 individual returns and selected a judgmental sample of 54 returns that used the third-party authorization to determine if the IRS properly processed appropriate indicators and designee information.

D. Evaluated whether the IRS continues to allow erroneous education credits by computer-identifying returns that claimed the education credit and met certain Adjusted Gross Income (AGI) criteria. We reviewed all 142 returns through March 22, 2002, that were allowed the education credit and also met the disallowance criteria of filing status and AGI limits to determine why the credit was allowed.

E. Reviewed a statistical sample of 75 accounts from 8,532 returns processed through March 21, 2002, to determine if accurate Self-Employment tax rates were used when taxpayers elected 1 of the optional methods.

V. Reviewed a judgmental sample of 270 Rate Reduction Credit (RRC) notices from 58,550 RRC notices issued for the week ending February 1, 2002, in the Austin and Fresno processing centers. These notices and corresponding accounts were reviewed to determine the causes of the errors associated with the 1-time RRC. In addition, we reviewed 110 RRC notices for the week ending March 8, 2002, in the Fresno processing center to determine if the notices were accurate.

Appendix II

Major Contributors to This Report

Michael Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs)
Stanley Rinehart, Director
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Sharon Buford, Senior Auditor
Larry Mart, Senior Auditor
Tina Parmer, Senior Auditor
Steven Vandigriff, Senior Auditor
Lawrence White, Senior Auditor
Cari Fogle, Auditor
Glory Jampetero, Auditor
John Ojeda, Auditor
Bonnie Shanks, Auditor

Appendix III

Report Distribution List

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Deputy Commissioner, Wage and Investment Division W
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Director, Submission Processing, Austin Campus W:CAS:SP:AU
Director, Submission Processing, Fresno Campus W:CAS:SP:F
Director, Strategy and Finance W:S
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:F:M
    Audit Liaison: Wage and Investment Division W:HR

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our report will have on tax administration. This impact will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Entitlements – Potential; 132,672 taxpayers did not receive $25.7 million in Additional Child Tax Credit (ACTC) after becoming eligible during the Internal Revenue Service's (IRS) error correction process (see page 4).

These 132,672 taxpayers represent part of a total population of 611,560 taxpayers that the Treasury Inspector General for Tax Administration (TIGTA) identified as potentially eligible to receive unclaimed ACTC totaling $238 million. The additional outcome measure for the remaining 478,888 taxpayers that failed to claim the ACTC totaling $212.3 million on their original tax returns will be reported in the TIGTA report titled, *Outreach Initiatives Need to Ensure Taxpayers Receive the Benefit of the Child Tax and Additional Child Tax Credits*.[1]

Methodology Used to Measure the Reported Benefit:

The TIGTA conducted a computer analysis during the filing season to determine if taxpayers were receiving the full benefits of new tax law provisions. We acquired the current (Tax Year 2001) IRS Returns Transaction File (RTF) records and developed specific criteria to select certain individual return data for taxpayers affected by the new tax laws. The selected data were further analyzed and generally updated once each week after posting to the Master File[2]. The 132,672 returns identified had Rate Reduction Credit (RRC) errors corrected in the Error Resolution System (ERS) but had not received subsequent adjustments to refund $25.7 million of unclaimed ACTC, based on our analysis of all 2001 U.S. Individual Income Tax Returns (Form 1040) that were added to the IRS RTF through May 31, 2002.

To specifically identify and quantify the credit not refunded to these taxpayers, we selected only those returns where IRS processing determined that the taxpayer was eligible for the Child Tax Credit (CTC) but not all the CTC had been used to offset the taxpayer's tax liability and the return contained the following three conditions. The taxpayer 1) did not claim the ACTC, 2) had sufficient earned income to qualify for the ACTC, and 3) showed a tax liability of zero.

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[1] Reference Number 2002-40-203, dated September 2002.
[2] The IRS' database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

Appendix V

Overview of Tax Law Changes That Affect Individual Income Tax Returns for the 2002 Filing Season

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)[1]

New 10 Percent Rate Bracket – Effective for taxable years after December 31, 2000, a new 10 percent income tax bracket was created for a portion of taxable income that is currently taxed at 15 percent. The bracket applies to the first $6,000 of taxable income for single, $10,000 for head of household, and $12,000 for married filing jointly taxpayers. For Tax Year (TY) 2001, the new 10 percent rate bracket will be delivered through a rate reduction credit (discussed below).

Reduction in Individual Income Tax Rates – For TY 2001, the marginal income tax rates for individuals will be reduced to 27 percent, 30 percent, 35 percent, and 38.6 percent. However, since the effective date of the reduction was not until after June 30, 2001, the actual annualized rates are 27.5, 30.5, 35.5, and 39.1 percent. The taxable income levels for the new rates will be the same as the current taxable income levels.

Rate Reduction Credit for 2001 – To provide immediate benefit of a new 10 percent rate bracket, a credit (new Internal Revenue Code (I.R.C.) § 6428) of 5 percent will be given in lieu of the 10 percent rate bracket for 2001. The credit will be based on income shown on tax returns filed for TY 2000 (instead of 2001). In general, checks will be issued in the amount of $300 for single, $500 for head of household, or $600 for married filing jointly taxpayers who timely filed their 2000 tax returns. Taxpayers will compute their actual 2001 credit on a worksheet provided with their 2001 tax return. The check they receive will be subtracted and any remaining credit will be claimed on their 2001 tax returns. Taxpayers whose checks exceed their credit (e.g., because they paid tax in 2000 but owed no tax for 2001) will not be required to repay the excess.

Increase and Expand the Child Tax Credit – Modifications to the child tax credit, effective for taxable years beginning after December 31, 2000, are:

- The credit (currently $500 per qualifying child) is increased to $600 per child in 2001-2004.
- The credit is made refundable to the extent of 10 percent of earned income in excess of $10,000.

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[1] *Source*: Joint Committee on Taxation, Summary of Provisions Contained in the Conference Agreement for H.R. 1836, the Economic Growth and Tax Relief Reconciliation Act of 2001, JCX-50-01 (May 26, 2001).

- The reduction in the credit by alternative minimum tax (AMT) is repealed.
- The current rule (which expires at the end of 2001) allowing the credit to offset the full amount of the taxpayer's regular tax and AMT is made permanent.

Increase in AMT Exemption – For tax years beginning in 2001-2006, the AMT exemption amount is increased by $4,000 in the case of a joint return or a surviving spouse (i.e., from $45,000 to $49,000) and by $2,000 in the case of an individual who is not married and not a surviving spouse (i.e., from $33,750 to $35,750).

Expansion of Authority to Postpone Certain Tax-Related Deadlines by Reason of Presidentially-Declared Disaster – Under current law, the Secretary of the Treasury can postpone for 90 days certain tax-related deadlines for taxpayers affected by a Presidentially-declared disaster. The Act extends this time period to 120 days.

No Federal Income Tax on Restitution Received by Victims of the Nazi Regime or Their Heirs or Estates – Under the Act, excludable restitution payments and excludable interest (as defined in the Act) shall not be included in gross income and shall not be taken into account for purposes of applying any provision of the Code that takes into account excludable gross income in computing adjusted gross income. The basis of any property received shall be the fair market value of the property at the time of receipt. This section applies to any amount received on or after January 1, 2000.

Taxpayer Relief Act of 1997 (TRA 97)[2]

Section 311 "Maximum Capital Gains Rates for Individuals" of the TRA 97 amends I.R.C. § 1(h)(2)(b) for tax years beginning after December 30, 2000. This amendment lowers the capital gains rate for individuals from 20 to 18 percent (10 to 8 percent for individuals in the 15 percent tax bracket) if the individual held the asset more than 5 years. For TY 2001, this provision will only apply to individuals in the 15 percent bracket. Under the TRA 97, the date that the 5-year holding period starts is different for individuals in the 15 percent bracket than for those in higher brackets. If the individual is in a tax bracket that is higher than 15 percent, the 5-year holding period applies to assets acquired after December 30, 2000. If the individual is in the 15 percent tax bracket, the asset does not have to be acquired after December 30, 2000, in order to have the 5-year period begin.

[2] Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C, 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).

Appendix VI

Management's Response to the Draft Report

COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

September 23, 2002

RECEIVED
SEP 24 2002

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: John M. Dalrymple
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Although the 2002 Filing Season Was Completed Timely, Customer Service Can Be Improved During Error Processing (Audit No. 200240022)

I appreciate your recognition of our success this filing season. We have overcome many challenges to implement the unique provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). I agree with your summary statement concerning our processing, " The IRS did very well to timely meet its processing goals for 2002 despite the significant increase in the workloads of Error Resolution System (ERS) and Notice employees at the 10 processing centers." Attributing the success of this filing season to the skill and dedication of our managers and employees is also on target. As your report notes, our employees worked extra hours when necessary. Their efforts helped us prevent material slowdowns in processing and ensured that we issued timely refunds.

As a result of our discussion on the recommendations in your companion report titled, "Outreach Initiatives Need to Ensure Taxpayers Receive the Benefit of the Child Tax and Additional Child Tax Credits", (Audit No. 200240057), we will mail information to the taxpayers identified in both reports to let them know that they may be eligible for the Additional Child Tax Credit (ACTC). Our mailing will provide appropriate forms and instructions for those eligible for the credit. Thank you for providing identifying information that will facilitate the process. In my response to that audit, I highlighted the efforts we made to inform and educate taxpayers on Child Tax Credits. We will continue to inform and educate taxpayers to claim their appropriate credits and file an accurate return. We believe that when taxpayers file accurate returns everyone benefits.

While your report recognizes that these taxpayers did not claim the credit, it does not acknowledge that we must have tangible information from the taxpayer to support the allowance of tax credits when the taxpayer has not claimed that credit on his or her return. Your statement, "Thousands of Taxpayers Were Prevented From Receiving Additional Child Tax Credits Totaling $25.7 Million" is not accurate because it assumes eligibility. Because of the complexity of the credits, we cannot assume taxpayer eligibility. We must have taxpayer verification to allow and accurately compute the credit. The statements on page five discussing our instructions to employees need clarification. Our employees did not make subsequent adjustments because we did not have the proper procedures or computer programming in place to determine eligibility or to accurately compute the credit. We had not anticipated this error condition until processing was underway. We acknowledge that our ability to react with proper programming and procedures to this one-time occurrence during the height of the filing season was limited. As your report acknowledges, our workload in ERS was overwhelming and we successfully corrected 6.5 million returns. While I agree advising these 132,672 taxpayers of their potential eligibility is appropriate, I also believe our actions reflected the proper customer focus by successfully processing 101 million refund returns and timely issuing $194.4 billion in refunds.

Your report acknowledges that our computer system is..."made up of a complex series of processing sub-systems that are linked and programmed to check the validity and math accuracy of the data provided." Your report also recognized that this year processing demands on the ERS system exceeded system capacity. Our systems are outdated, have limited capacity, capability and are difficult to program. While I disagree with your recommendation, I recognize your intent and endorse the concept.

I look forward to the success of our Modernization effort that will allow a more individualized approach to processing and problem solving. In the interim, I assure you that although we make difficult decisions, reducing burden and providing fair and equitable treatment for all taxpayers is always our first consideration.

I have reviewed your measurable benefit and disagree that it represents an actual taxpayer entitlement; I agree they are potentially eligible for the ACTC. Based on the information in the report, the dollar amount associated with this potential entitlement appears reasonable.

If you have any questions, please call me or Ronald S. Rhodes, Director, Customer Account Services, at (404) 338-8910.

Attachment

Attachment

RECOMMENDATION 1
The Commissioner, W&I, should consider developing a proactive approach in the ERS to apply appropriate credits affected by the corrections made during error processing.

ASSESSMENT OF CAUSE
The ERS system did not identify unclaimed Child Tax Credits on returns containing errors.

CORRECTIVE ACTION
The ERS systems and supporting processes are not proactive. The system has limited capability and capacity and would require complicated computer coding routines for us to us it as a proactive tool. The high priority demands associated with implementing new tax law, maintaining existing systems, and supporting our Modernization efforts prevent us from implementing this recommendation.

IMPLEMENTATION DATE
Not Applicable

RESPONSIBLE OFFICIALS
Commissioner, Wage & Investment Division